Lending in the Time of COVID-19

By Ravi Arps

This paper analyzes the lending environment from the perspective of debt capital markets in light of COVID-19. Stonybrook interviewed a number of debt markets including regional banks, alternative asset managers, under-leveraged mutuals, and private equity firms in order to understand varying perspectives of the capital markets' lenders.

Universally, it appears that debt capital markets are continuing to lend in the COVID-19 environment, though they are proceeding cautiously and slowly. In March and April, when the equity markets collapsed, lending was briefly put on hold. However, it resumed shortly afterwards.

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While some regional banks are now at risk, others are not and are continuing to lend. Private equity is continuing to lend, especially lenders that have recently raised new funds that they are in the midst of deploying. Investment managers are continuing to lend, though focused intently on downside protection and less actively in the private market. Under-leveraged mutuals continue to be open to lending in this environment; however, for some there does not seem to be much activity while others are actively evaluating opportunities.

Who are debt capital markets lending to?

All markets will consider new prospective issuers; however, the preference is for existing clients. Regional banks continue to lend to brokers and carriers and are seeing an increase in acquisition opportunities for their broker client base. Regional banks prefer existing clients, as they have found that the process with prospects might take two or three times as long without the luxury of meeting face to face. Moreover, lending has actually increased amongst existing clients — as much as over half of the overall portfolio — whether due to small increases to outstanding debt, the addition of a revolver, or other concessions.

On the broker side, investment managers are continuing to issue collateralized loan obligations (CLOs), while on the carrier side, they believe that there could be more opportunities in the next few months. Many carriers are not yet capital constrained and still want to operate with business as usual. Unfortunately for private market issuers, there is typically a higher threshold than in the public markets due to its illiquidity. Furthermore, yields in the public markets can reach north of 20 percent, making it harder to execute on the private side.

Similarly to banks, private equity is increasingly offering add-on investments to existing borrowers. Lending has picked up recently with several new platforms closing deals at the moment.

Under-leveraged mutuals typically approach investments in other insurance entities or insurtechs, whether debt or equity, primarily from a strategic standpoint, given that their business is insurance. They are seeking investments into entities that might become a partner or strike up a relationship with them in the future through a surplus note, senior debt, equity, or M&A. Many of the companies have existing debt and a proven ability to repay, with high ratings and solid relationships with regulators.

Has underwriting criteria changed, and if so, how?

For the most part, underwriting criteria remains the same, though underwriting metrics are being scrutinized more carefully.

Regional banks are not implementing any covenants above what is usual; however, they are examining projections, leverage ratios, and investment portfolios more closely. Renewal rates have kept up on the broker side with rates hardening overall; however, they have seen a 5 percent dip in commission revenue. Others show projections improving, and it may depend on the type of business — whether life and health, property and casualty, or those economically dependent on the performance of the economy. Workers' compensation writers don't expect higher claims, but rather drops in revenue with fewer people employed or needing insurance. On the life and

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health side, they have not seen much drop off yet in terms of new sales. While previously they might lend to entities with leverage above three times senior debt or four times total leverage, their appetite for that has now decreased. This is especially true for smaller, new clients with EBITDA below $5M, who might require two to 2 1/2 times the leverage. Lastly, investment portfolios are being examined closer than before.

Investment managers have grown more focused on the assets within the portfolio of those entities they are lending to, which makes things particularly difficult for insurance carriers if they are below their claim reserves. Additionally, the focus is on companies with less-drawn credit facilities, as they are anticipating various scenarios that might occur, what rights they might have should a second wave of COVID-19 hit, and if the entity were to go into bankruptcy.

Private equity has observed that with fewer lenders in the market, they are able to lend at more conservative leverage levels and LTV ratios, similar to what the rest of the market is targeting.

For under-leveraged mutuals, liquidity has become extremely important. They are focused on the issuers' ability to pay, any other obligations they might have, and where they would fall in the capital structure. Additionally, mutuals are observing potential COVID-19 exposures from a claim's perspective. For example, they would look at the sector they are insuring, to assess whether it includes travel insurance, airline, hospitality, etc. as well as the profile of the book and underwriting practices. Other important criteria include profitability, leverage ratios close to one, and having less than 25 percent debt ratio, as is typical.

Have their prices changed — if so, how and how much?

Overall, pricing has gone up, though not substantially. Regional banks have adjusted pricing by 25-50 bps on the investment grade side, with a slightly larger increase for non-investment grade. Investment managers, on the other hand, have adjusted their pricing by approximately 100 bps due to the uncertain environment. Private equity has observed that the mid-market pricing environment seems to be 150-250 bps higher than the pre-COVID-19 environment. Some under-leveraged mutuals may not price to the precision of what the rest of the market is doing, though some believe that high quality rates haven't changed much. For smaller companies, spreads may have widened; however, at the same time the base interest rate has moved lower, which might offset the change in spread. Others have observed prices changing significantly with a 40-50 percent increase given the illiquidity of the products they are offering.

How do debt capital markets view the credit worthiness of the insurance industry as a whole?

Perspectives on the market are generally mixed. Regional banks remain relatively bullish and still have a very positive view of the credit worthiness of insurance entities since surplus levels remain strong on property and casualty and the life side, so they do not see any major problems developing.

Given that the market is hardening, private equity sees the rate environment as extremely positive. Private equity generally likes the sector, although it is somewhat insurance sector specific and typically shies away from financing companies taking carrier risk, though some have had much success with fee-based entities like managing general agents.

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Investment managers have a slightly negative view, although this view is less related to COVID-19 and is more of a general catastrophe loss view. As long as there is ongoing premium, they see the effect of COVID-19 just like any other business.

Under-leveraged mutuals seem more bearish given that some companies will be affected due to lawsuits, negative growth on new business, and an increase in liabilities. This may disproportionately affect smaller companies with litigation costs and settlement. Companies that insure nursing homes, for example, may assume around $10M in premium and could face double or triple that size in lawsuits. On the other hand, some companies will become stronger with large balance sheets and may end up benefitting from the crisis.

Conclusion

Debt capital markets remain interested and active in deploying capital into the insurance industry. Although rates have increased slightly, the impact and overall perception of the market generally has fared well with respect to the rest of the economy.

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Stonybrook, focused exclusively on the insurance industry vertical, is an investment banking and reinsurance broking firm with headquarters in New York City, and offices in London and Bermuda.